

Creating economic opportunities and shared value in society

Speech by Nobuchika Mori
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Thank you, Ms. Tracy Doi, for your kind introduction. Good morning, ladies and gentlemen. It is a great honor to have the opportunity to speak at the US-Japan Council's Annual Conference.

I also thank Ms. Irene Hirano Inouye, President of the USJC, for bringing me back to this venue in Washington D.C.

I am saying this because this location makes me recall fond memories of the years I spent in this city around 20 years ago. For three years, from 1996 to 1999, I worked as Deputy Treasurer at the Inter-American Development Bank, which is just two blocks away from here. Once or twice a week, I enjoyed lunch at this hotel in those days.

I also worked in the U.S. as the Chief Representative for the Japanese Ministry of Finance in New York between 2003 and 2006. During that period, I became well acquainted with Wall Street bankers as well as regulators at the New York Fed. I still get together with them when I have time.

The experience of my years in D.C. and New York and the personal contacts that I made have been extremely helpful for me to serve at the Financial Services Agency, or FSA, where I have been responsible for supervising financial institutions since 2006.

Capital market developments and household assets

From my experience, I am well aware that Japan has a lot to learn from the U.S. when it comes to how the financial world works.

Among the most important virtues of the financial system in the U.S. are the depth of the market, characterized by the diverse market players, ample liquidity, and corporate governance culture that encourages companies to attain continued improvement of their corporate value.

The well-developed capital market in the U.S. brings benefits to the American people. Over the past 20 years, financial assets held by American households more than tripled, but those by Japanese increased only by 54%. Now, the assets held by American households are five times as large as those held by Japanese.

This gap is due in part to the differences in demography and in the economic performances of the two countries over the past two decades. Another important factor is the difference in the two countries' approach to investment. The U.S. has encouraged American people to diversify their portfolios by offering tax breaks through the 401k plan and the IRA. At the same time, a culture of robust corporate governance has flourished, pushing CEOs to grow their companies' value. As a result, investment has brought benefits to America.

Japanese families hold most of their financial assets in the form of cash or bank deposits. They invest only 19% in stocks and mutual funds, compared to 46% in the U.S. However, 30 years ago, to my surprise, it was as low as 22% in the US. Now, in Japan, we are encouraging Japanese to diversify their asset portfolios and make cumulative investment over the long term by providing tax breaks through a Japanese version of the IRA called iDeCo and a special savings account for retail investors called NISA.

What is also important is that asset owners attain more sophisticated investment skills. In Japan, there are huge asset owners, such as the Government Pension Investment Fund, and Japan Post Bank, with one to two trillion dollars of assets respectively, but they have until recently invested mostly in JGBs. Since Prime Minister Abe took office, we have been encouraging these asset owners to become more sophisticated investors and enhance their governance. As a result, their investment portfolios have become much more diversified across a variety of asset classes and regions.

Such diversification of portfolios will also lead to growth in Japanese investment in domestic stocks. To deliver successful results, Japanese companies need to increase their corporate value. To this end, Japan has developed the Corporate Governance Code and the Stewardship Code. The principles of fiduciary duty have also been introduced to promote competition among financial institutions to serve in the best interests of customers.

The corporate profit in Japan more than doubled and household financial assets have expanded by 2 trillion dollars in the nearly five years under the Abe administration.

Responding to growing interest of major U.S. investment funds towards Japan, the FSA launched the *Financial Market Entry Consultation Desk* earlier this year to support their “fast entry” to Japanese markets. The accumulation of world-leading fund managers and investment advisors will promote sophisticated asset management and diversified investment practices, bringing stable returns to the Japanese investors. Such successful experience will attract additional funds to the Japanese capital markets. This, in turn, will further invigorate asset management businesses in Japan. The FSA has been striving to elevate Tokyo’s position as an international financial center through this virtuous cycle.

Regulatory and supervisory approaches

As I noted, Japan has much more to learn from the U.S. about the world of finance. However, a decade earlier than the U.S., Japan had to learn a bitter lesson from its own banking crisis, which I would like to share with you.

Starting in November 1997, exactly 20 years ago, large financial institutions in Japan failed one after another; Yamaichi Securities and the Hokkaido Takushoku Bank in that month, followed by the Long-term Credit Bank and the Nippon Credit Bank in 1998. The Japanese government injected public funds into banks to stabilize the banking system, and in 2000, the FSA was established in order to strengthen the regulation and supervision of financial institutions.

For several years, the FSA scrutinized banks' loan classification to urge the disposal of bad loans to clean up their balance sheets. It also kept a close watch on banks' activities to ensure that their conduct was in compliance with regulations. The consolidation and shakeout of financial institutions suffering from insufficient capital position accelerated. The strictness of the FSA's approach to the industry was such that the "FSA" was often referred to as standing for the "Financial Sanctions Agency," not the "Financial Services Agency."

While the tightened regulation and supervision have contributed to ending the crisis, new problems have also emerged. It has stifled constructive dialogue between the authorities and banks, making it difficult for regulators to grasp market developments and to detect any potential risks that may be rising.

Another problem is that banks have become overly cautious about providing loans because of the strict loan classification rules. Even today, many SMEs, which account for 70% of the jobs in Japan, are finding it hard to borrow from banks unless they can offer sufficient collateral.

After the global financial crisis, a wave of regulatory tightening continued in the U.S. and Europe, as was the case in Japan two decades ago. Based on our experience, we have been stressing the following points in the global regulatory community;

- First, we need to attain not only financial stability but also sustainable growth in a balanced manner;
- Second, we need to assess the effects and unintended consequences of regulations; and
- Third, we must adopt a more “forward-looking” approach, as future threats will be different from past ones.

Sole reliance on tightening regulations may have been changing during the past few years. There has also been an evident change of course in the U.S. under the present administration, moving towards a more balanced approach to create economic opportunities.

Finance and the economy

While over-regulation could pose side effects, tightening regulations is often supported by public antipathy towards the industry by the perception that banks symbolize “greed.” It is also supported by a notion that they are far distant from the real economy and are indulged in playing “the money game.” The game creates an economic bubble that will eventually burst, and as a consequence, the real economy and the taxpayer will have to foot the bill, while Wall Street bankers continue to receive generous pay.

So there may be a growing disconnect between the world of finance and the wider real economy. Still, I believe that banks play an important role to increase clients’ corporate value, bringing stability to ordinary people’s lives and achieving economic growth.

However, to what extent do banks actually play such a desirable role right now?

At the moment, the world is awash with liquidity due to central banks' monetary easing. Banks may find it difficult to add value to their customers by simply taking deposits and making loans. As we witness new technological breakthroughs, banks are facing pressure to shift from a capital-intensive model to a knowledge-intensive one. The extent of their branch networks or the size of their balance sheets will no longer decide their competitiveness. Going forward, the deciding factor will be how successfully banks can provide useful advice and financing to revitalize companies and, by extension, the communities they serve.

In Japan, there are potential funding needs from corporates, particularly local SMEs. Faced with a shrinking and aging population, they need to streamline their business operations, while there are also strong appetites to start new businesses. Some banks are indeed already engaged in business with a truly customer-oriented approach, and are generating stable earnings. Such banks will be able to create long-lasting relationships with their client companies, which will bring in a steady stream of revenue even under the current challenging environment. I hope to see them achieve prosperity together through creating value for both sides.

Turning to the U.S., SMEs are also the cornerstone of the economy as they create 50% of all jobs. Improvement of SME corporate value and productivity will create further dynamism in the U.S. economy. This may also, through raising workers' wages, lead to bring the society together.

We need to continuously better our respective financial systems so that they can best serve the real economy and society. I believe this could be a common agenda for the U.S. and Japan. Peter Drucker rightfully described business enterprise as "a creature of society and economy." In his best-seller book "Management," he emphasized that "[t]he enterprise exists on sufferance and exists only as long as society and economy believe that it does a job, and a necessary, useful, and productive one." I

believe that finance is no exception.

Japan-U.S. cooperation in achieving a common goal

Let me conclude.

A financial system varies across countries reflecting each country's history, culture and economic structure. At a glance, our two countries' systems may seem very different. However, through my experiences in the two countries, I have come to believe that, in both countries, the financial sector is expected to play an extremely important role in realizing sustainable growth, as well as in improving people's welfare and happiness through creating shared value with customers.

I strongly believe that cooperation in the financial sector between the U.S. and Japan, by the authorities as well as the industry, will definitely contribute to the global community and the further deepening of the U.S.-Japan alliance.

Thank you for your kind attention.